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Nos. 00-590, 00-511, 00-555, 00-587, 00-602

IN THE

Supreme Court of the United States

AT&T CORP.,

Petitioner,

v.

IOWA UTILITIES BOARD, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF OF AT&T CORP.

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INTRODUCTION AND SUMMARY OF ARGUMENT

1. The LECs' respondents' briefs have not defended the Eighth Circuit's judgment on TELRIC. The Eighth Circuit invalidated only the subsection of TELRIC that requires that rates be based on efficient replacement costs, and it upheld TELRIC's ban on "consider[ing]" the LECs' historical book costs. As is now undisputed, these holdings would require that network element rates be based on either (1) the universally discredited method of determining the costs of reproducing obsolete technology at today's prices or (2) a short run incremental cost method in which LECs recover their operating expenses but receive no recovery based on the value of their fixed capital investments.[1]

Because the LECs have no interest in defending either alternative permitted by the Eighth Circuit's judgment, they have devoted their "respondents' briefs" to rearguing the claims that were made or should have been made in their petitioners' brief. In particular, they here argue that the FCC was required to reject TELRIC and to adopt a method in which network element rates are based on the LEC's historical "sunk" costs, either in whole or in substantial part.

There is no merit to the claims that TELRIC violates the statutory requirement that network element rates be "based on the cost of providing the element." The Order's unchallenged findings and the uniform decisions of regulatory and accounting bodies all establish that TELRIC represents the "real," "economic," and "current" costs that the LECs incur in providing their existing network elements.

The LECs' arguments that TELRIC is arbitrary and capricious rest on a series of misstatements of the FCC's

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[1] In their opposition to the petitions for certiorari (p. 11), BellSouth, SBC, and Verizon ("Bell") contended that the Eighth Circuit said no such things, but Bell's claim was refuted in AT&T's Petitioner's Brief (pp. 37-40), and Bell has now abandoned it.

Order. Their principal contention is that the FCC did not understand that LECs' investments are "sunk" once they are made and that the practice of "anticipatory retardation" means that LECs' networks inherently contain a mix of new, efficient and older, costlier technologies. However, the FCC's Order explicitly acknowledged these facts, and TELRIC requires states to establish the depreciation and rate-of-return components of the rates at levels that reflect the "sunk" character of LEC investments and all the risks of operating under TELRIC and the 1996 Act.

2. The Eighth Circuit's refusal to reinstate the FCC's network element combinations rule was erroneous. The rules reasonably prevent discrimination, and the Eighth Circuit's contrary holding rests on the same interpretation of § 251(c)(3) that this Court has expressly rejected.

I. TELRIC IS AUTHORIZED BY THE STATUTE AND IS MANIFESTLY NOT ARBITRARY.

As was explained in AT&T's prior briefs, TELRIC represents a manifestly permissible method of implementing the 1996 Act. This "bottom-up" method is the most direct, reliable, and administrable method both of identifying the real and economic costs that LECs incur to provide the network elements required to serve today's retail customers and of preventing LECs from illicitly foisting retail costs and costs of serving future customers on their retail competitors. At the same time, because the FCC's TELRIC regulations provide that the depreciation and rate-of-return components of the rates are to reflect all the risks of operating under this regime, the FCC's TELRIC regulations unequivocally permit states to set rates that reasonably and fully compensate the LECs.

By contrast, a "top-down" historical-cost method would begin with book costs that regulators have found to be unreliable and inflated and that bear no relationship to today's costs of meeting existing demand. It would further depend on a series of adjustments or arbitrary cost allocations to exclude

phantom or imprudent investments, to exclude retail costs, to exclude facilities built to serve future customers, and to determine costs in areas of different population densities. In practice, this method would almost assuredly produce rates that are wildly in excess of the costs that the LECs incur when they use their local loops and other bottleneck facilities to provide their own competing retail services. The result would be "discrimination" that violates § 252(d)(1)(A)(ii) and a "price squeeze" that would prevent retail competition from developing in the "*un*shared" parts of the network. Cf. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 429 (1999) (Breyer, J., concurring and dissenting in part).

That is why "total service" long run incremental cost methods like TELRIC have long been used by the FCC, other federal agencies, state commissions, and antitrust courts to determine the maximum prices that incumbent monopolists may charge their retail competitors for access to essential facilities. That is why the European Commission, its member states, and other foreign regulatory bodies have adopted the method. And that is why the state commissions who have been applying TELRIC for the past five years have defended TELRIC's validity in this Court. See NARUC Br. 12-14.

The LECs challenge TELRIC by making a series of claims that are pervaded with rhetoric, but that lack any substance.

1. First, the LECs incongruously rely on the "necessary or impair" standard of § 251(d)(2), which determines the network elements that LECs are required to make available. The LECs note that this Court held that the FCC misinterpreted these terms in their original 1996 Order; they contend that the FCC made the same error in the intervening decision on remand (which is now before the D.C. Circuit), and they suggest, on these bases, that the network elements that the FCC has designated are facilities that CLECs could readily duplicate. Bell Br. 2; Qwest Br. 26-27.

But TELRIC is the standard that applies to pricing the network elements that are properly designated under § 251(d)(2), and there is no dispute that the facilities that have been designated network elements are "generally . . . bottleneck[] monopol[ies]" under any standard. Order, ¶ 702 (JA 395). For example, in the pending D.C. Circuit appeal, the LECs have not challenged the FCC's requirement that they provide access to the ordinary copper local loops that AT&T now leases and combines with its own switching and other facilities to offer local service to business customers. AT&T Pet. Br. 14-15. This local-services competition is tenuous at best, and it would end if the rates for these bottleneck facilities exceeded the economic costs that LECs incur when they use the same facilities in their competing retail services.

2. AT&T has previously refuted the claims that the FCC violated the statutory requirement of § 252(d)(1)(A)(i) by requiring that network element rates be "based on the use of the most efficient telecommunications technology currently available." 47 C.F.R. § 51.505(b)(1). The LECs are simply wrong that § 252(d)(1)(A) requires that cost determinations be based on the specific costs of the LEC and its network. See AT&T Pet. Br. 36-37. Further, even if the Act imposed this requirement, TELRIC measures the "actual costs" that each LEC incurs in providing its existing facilities. *Id.* at 28-34.

Long run incremental cost is a well-accepted method of determining the costs of individual firms. Yet all long run incremental cost methods can be characterized as making determinations based on a "hypothetical carrier" and an "ideally efficient" network that does not exist. Compare Bell Br. 16; Qwest Br. 2-3. Long run incremental cost methods inherently assume "a wholly new . . . plant." D. Watson & M. Holman, *Price Theory And Its Uses* 195 (4th ed. 1977). As the European Commission explained, the long run "is the time horizon in which the firm could adjust (downwards or

upwards) all of its inputs, including the size of each and any of its production plant, to meet a decrement or increment in the volume of production." Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market* § 3.3, 1997 C(97)3148 ("*European Commission Report*"). *Accord* Order, ¶ 677 & n.1682 (JA 378) (citing W. Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977)). Any long run incremental cost method further assumes that a firm will select "that plant which produces its output at the lowest possible cost." Baumol, *supra*, at 291. Thus, when state commissions and the FCC used long run incremental cost methods to set maximum prices for access to essential LEC facilities before the 1996 Act was passed, they made their determinations based on "the least-cost, most efficient technology that is currently available for purchase."[2] Foreign regulators apply this same standard.[3]

Contrary to Bell's claims, the "current cost" of using the entity's existing plant and equipment is a function of its efficient replacement cost, not the price that was paid for the equipment up to "30 years" ago. Compare Bell Br. 5. The past expenditures are "sunk," "unavoidable" and irrelevant to the cost of using equipment today. The cost of using equipment today is a function of the facts that today's use causes it to wear out faster and to have to be replaced sooner. Replacement cost measures the value of the equipment, and replacement cost therefore is the basis for measuring the

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[2] *A Methodology To Determine Long Run Incremental Cost*, 156 P.U.R.4th 1, Ex. A at 13 (Mich. Pub. Serv. Comm'n 1994); *see* AT&T Pet. Br. 11-12.

[3] AT&T Pet. Br. 21; *see also* Australian Competition & Consumer Comm'n, *Access Pricing Principles – Telecommunications* 23 (1997) ("the most efficient technology that is commercially available"); Infocomm Dev. Auth. of Singapore, *Appendix 1: Interconnection/Access In A Fully Liberalized And Developed Convergent Environment, in Second Consultation June-30th*, ¶¶ 5.1.1, 5.1.2.3 (2000).

"real" and "economic" cost of the use of the equipment. See AT&T Pet. Br. 19-21 & 30-31; S. Breyer, *Regulation and Its Reform* 38 (1982).

As the European Commission has stated, once an investment is made, the firm "can either sell the asset to the highest bidder or it can use the asset to produce a good or service which the firm sells to generate an income." *European Commission Report* § 3.3. The cost of using the asset is the opportunity cost of using it rather than selling it at its value. It is determined by the prices of the most efficient substitutes that are commercially available.[4] W. Baumol & J. Sidak, *Toward Competition In Local Telephony* 60 (1994). Thus, in addition to the decisions of the European Commission and other regulatory bodies cited in AT&T's Petitioner's brief (19-21), accounting standards provide that "[t]he current cost of property, plant, and equipment owned by an enterprise is the current cost of acquiring the same service potential ... as embodied by the asset owned," not what was paid for it years ago. 1 Financial Accounting Standards Bd., *FAS No. 89: Financial Reporting and Current Prices, in Original Pronouncements: Accounting Standards as of June 1999*, at 919, ¶ 18 (1999).

The LECs also attempt to dispute that the decisions of other bodies confirm that TELRIC represents the economic costs that monopolies incur in providing essential facilities. Qwest asserts that the prior antitrust, FCC and state decisions cited in AT&T's Petitioner's Brief only set a "price *floor*" of short run or long run incremental cost for a monopolists' retail services. Qwest Br. 36. That is false. The decisions also set a price ceiling for the essential inputs that are provided to competitors of total service long run incremental cost plus a

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[4] Bell's claim (Br. 19) that there is no "market" for telephone networks is irrelevant and erroneous. There is a market to supply the facilities used in providing network services, and it is the prices of the most efficient technologies currently available that determine replacement costs.

markup for joint and common costs: *i.e.*, TELRIC. AT&T Pet. Br. 11-12.

Similarly, both the European Commission and Oftel (the FCC's British counterpart) expressly adopted the same total service long run incremental cost standard to govern the pricing of network elements provided by their incumbent LECs.[5] In suggesting otherwise, Bell (Br. 35) relies on the irrelevancy that the European Commission and Oftel authorized the use of alternative measures during the interim period before long run incremental cost studies could be developed and refined. The FCC's Order did the same thing. Order, ¶¶ 787-827 (JA 894-914).

There also is no substance to Bell's claim (Br. 34-35) that there are critical differences between TELRIC and the efficient replacement cost methodology that the ICC has used to set maximum railroad rates for captive shippers. Contrary to Bell's mistatement (*id.* at 34), the ICC method does not assume a railroad built to serve only "one shipper" or group of shippers "on a particular route" and thus does not deny shippers the economies existing between that route and the rest of the railroad. To the contrary, like TELRIC, the ICC's method was developed for the express purpose of "taking advantage of economies of density" and allows rates to be set based on the replacement cost of the entire railroad or any hypothetical routes that enjoy economies of scale, scope or density. *Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 & 547 n.75 (1985), *aff'd*, 812 F.2d 1444 (3d Cir. 1987).

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[5] *European Commission Report*, §§ 3.3, 3.5; Oftel, *Access to Bandwidth: Indicative Prices and Pricing Principles*, ¶¶ 3, 9 (2000). Bell's Brief misrepresents Oftel's more recent order. Because LRIC cost models had not been finalized for a single element (the local loops), Oftel there decided to set interim rates by using the results of the incumbent's "'top down'" cost model as a "starting point," and using the results from the most recent proposed long run incremental cost model "to ensure that only relevant costs are included within the calculation." *Id.*

3. The LECs' remaining arguments are that the adoption of TELRIC was arbitrary and capricious. Their basic contention is that the FCC's TELRIC method is suitable only for markets like "pork bellies" and other commodities. Bell Br. 28. They contend that the method is wholly inappropriate in capital-intensive businesses like telecommunications in which equipment has useful lives of up to 30 years, in which facility investments are thus "sunk" once they are made, and in which technology costs are rapidly declining (at least in some segments). They assert that the FCC overlooked these obvious facts about the industry in concluding that TELRIC reasonably "mimics" the prices that would prevail in competitive markets. These claims are refuted by the face of the FCC's Order.

a. The LECs' primary claim is that the FCC's Order rests on the false premise that LECs' networks should always be comprised exclusively of the most efficient technology and that the LECs should adopt the "suicidal business plan" of constantly "tearing down its existing network and building a new one from scratch." Bell Br. 17-18, 21, 25-27; see Qwest Br. 13, 29-31. As the LECs correctly state, no carrier rationally would or should replace functional "sunk" equipment merely because more efficient technology becomes available. Rather, carriers practice "'anticipatory retardation'" in which they delay investment in new and more efficient technology until such time as the relative advantages that the new equipment offers are sufficiently great that it is clear that the carrier can earn the anticipated return and depreciation over the life of the new plant. 1 A. Kahn, *The Economics of Regulation* 119 n.91 (1988).

The LECs' claim is a strawman. Making efficient investment decisions and the costing and valuation of assets are entirely separate matters. See C. Horngren, *Cost Accounting: A Managerial Emphasis*, 378-79, 396-400 (10th ed. 2000); 1 A. Kahn, *The Economics Of Regulation*, 118-19

(1988). TELRIC, in turn, is not a prescription of criteria to govern the LECs' investment decisions. It is a method of valuing the investments that the LECs have made for purposes of setting rates. In turn, TELRIC's valuation of the LECs' facilities is one of inputs that is used to determine two of the components of the LECs' "economic" costs of providing network elements: the annual depreciation allowance and the return on the LECs' investment.

In adopting TELRIC, the FCC acknowledged the very characteristics of telecommunications and other capital-intensive industries that the LECs accuse the FCC of ignoring. The FCC expressly noted that local exchanges are capital-intensive businesses characterized by "significant sunk investment [and] declining technology costs." Order, ¶ 686 (JA 384). In this regard, the FCC was relying on the testimony of Professor Baumol and the others who had acknowledged "these principles" and demonstrated that TSLRIC represents the stream of revenues that provide full compensation to firms in capital-intensive industries, be they competitive industries like semiconductors or monopolies like local telephone networks. Compare AT&T Reply Comments (May 30, 1996), W. Baumol et al. Reply Aff. at 2 (JA 141-42), with Bell Br. 29-30 n.28. The FCC found that the depreciation and cost of capital components of TELRIC fully account all the risks and costs that LECs "incur" due to the combination of significant "sunk investments, declining technology costs, and competitive entry." Order, ¶ 686 (JA 384); see also *id.* ¶¶ 687-689 & 702-703 (JA 385-86 & 395-96). In short, the FCC expressly considered and specifically rejected, the LECs' claims, holding that, "even in the presence of [the LECs'] sunk costs, TELRIC-based prices are an appropriate pricing methodology." *Id.* ¶ 703 (JA 396).

Indeed, although the LECs' briefs are filled with selective quotations of statements by their economic experts, these economists admitted in their testimony before the FCC that

TELRIC will result in fully appropriate network element prices if depreciation and cost of capital calculations reflect all the risks of operating under this regime. See AT&T Pet. Br. 16-17 (citing testimony of Kahn, Tardiff & Hausman); *accord* 1 A. Kahn, *The Economics of Regulation*, 121-22 (1988). The LECs ultimately concede this point. Bell Br. 29. However, the LECs contend that the FCC rules for calculating the depreciation and rate of return components of network element rates are inadequate and are incapable of being implemented by state commissions in a manner that reasonably compensates LECs for the economic costs of providing network elements. These claims, too, rest on misstatements of the FCC's Order.

b. Depreciation determines the percentage of the value of an asset that a LEC is allowed to recover in its rates in any one year. The depreciation component of a network element rate is a product both of the valuation of the asset (here replacement cost) and the state-determined rate of depreciation during the period in which the network element rate remains in effect. For example, if an asset is valued at $100 and the depreciation rate is 20%, the annual depreciation that will be included in the rate is $20. Obviously, a higher depreciation rate can entirely offset the consequences of a lower valuation of a network facility. Thus, even if it were the case that replacement costs for all network elements were constantly declining – as it is not – the LECs are simply wrong in asserting that states cannot establish depreciation allowances that provide LECs with adequate depreciation and capital recovery under TELRIC. See Bell Br. 4.

The LECs' contrary arguments appear to rest on the false premise that TELRIC requires states to set depreciation rates that reflect only the wear and tear on the asset which limits its physical useful life but that ignore the reductions in the value due to declining technology costs. That is incorrect. TELRIC requires that states use "economic depreciation rates" in setting network element rates. 47 C.F.R. § 51.505(b)(3). The

FCC made it explicit that the depreciation components of the rates must reflect not just wear and tear and the asset's physical life, but also "the true changes in economic value of an asset" (Order, ¶ 703 (JA 396)) and the "expected declines in the value of capital goods." *Id.* ¶ 686 (JA 384).

Thus, the FCC's regulations permit (and require) states to establish depreciation rates that compensate LECs for the expected loss in economic value of their network elements. For example, if a switch that cost $100 today had a useful physical life of 10 years and if the replacement cost is declining by 10% a year, it would violate TELRIC if states set depreciation at 10% of the replacement cost each year over ten years. Cf. Bell Br. 4. That would result in depreciation that totalled $65.10 over the life of the switch (*i.e.* $10 in depreciation the first year, $9 the second, $8.10 the third, etc.). TELRIC would here require the state to select an accelerated or other method in which the switch were depreciated over a period of less than ten years.[6] The LECs can then receive annual depreciation allowances that total $100 over the economic life of the switch.

Bell (*id.* at 33 n.25) and Qwest (Br. 35-36) erroneously assert that the Act or the FCC's rules requires states to recalculate TELRIC rates continuously or annually. Indeed, the almost uniform state practice (which the LECs defend) is to establish rates that remain in effect for a period of three years or longer. However, if appropriate depreciation calculations are made under TELRIC, LECs will be protected

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[6] For example, an accelerated depreciation method might provide for depreciation of $20 the first year, $19 the second, $18.10 the third, *etc.* – and total $100 over a period of approximately 5.5 years. Alternatively, a straight-line method might allow depreciation of $14.30 per year over a period of about seven years, again totaling $100.

against expected declines in the loss of value of their assets under any scenario.[7]

The LECs misstate the FCC's Order in other ways. They claim that FCC has required states to set network element rates based on the depreciation rates that the FCC uses in regulating LECs' interstate exchange access services – unless the LECs prove that they currently face facilities-based competition in the provision of network elements. Bell Br. 32-33. This is simply false. The FCC's rules unconditionally require the use of economic depreciation that takes into account expected changes in technology costs, irrespective of whether there are any alternatives to the LEC's network elements. The FCC's Order states (¶¶ 687-688, 702-703 (JA 385-86, 395-96)) that the likelihood that alternatives will be developed to LEC network elements is a consideration in making the separate rate of return and cost of capital determinations (where that fact is relevant), *not* in the calculation of depreciation rates (where it is irrelevant).

Further, to the extent that the Order requires states to use the FCC's prescribed depreciation rates if no other alternatives are presented, the FCC plainly acted entirely reasonably. Contrary to the LEC's suggestion, the FCC depreciation rates have been set to reflect the expected declines in asset values, and the FCC has found that these rates reflect all the risks that LECs face and that LECs have substantial depreciation reserve surpluses. AT&T's Resp. Br.

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[7] Bell now contends (Br. 4 n.4) that it would incur losses if there were an "unexpected[]" 20% drop in the replacement cost of a plant (from $100 to $80) after a state set network-element rates in year one and before it recalculated those rates in year two. This argument rests on the implausible assumption that states would not adjust the depreciation rate in the second year, and would readopt the same annual depreciation rate (10%) – such that the allowed depreciation would drop from $10 to $8. Further, even if LECs were to end up bearing the risk of unexpected declines in asset values, they also reap the benefits of unexpected developments that enhance asset values.

27. More fundamentally, the FCC's prescriptions are merely a default rule. The Order (¶ 686 (JA 384-85)) expressly allows parties to "propose" and the states to adopt "specific depreciation rate adjustments that reflect expected asset values over time," and on occasion states have set network element rates based on depreciation lives that are as much as 50% shorter than those assumed by the FCC.[8] Contrary to the LECs' misstatement (Bell Br. 32 n.24), the FCC has upheld the lawfulness of such state measures.[9]

TELRIC's depreciation rules thus reasonably protect LECs against the risks that result from using current replacement costs to value LECs' sunk investments in network element. These risks exist whether or not LECs continue to have monopolies over network elements, and the depreciation rules allows states to provide LECs a return *of* their investments.

c. The cost of capital/rate of return components of rates are designed to provide LECs with a return *on* their investment that is sufficient to reflect all the risks that LECs face in their businesses and to assure that they can continue to attract private capital. See S. Breyer, *Regulation and Its Reform* 40-47 (1982). The FCC fully addressed this interest of LECs. It required that states set TELRIC rates that include "the forward-looking cost of capital." 47 C.F.R. § 51.505(b)(2). The Order acknowledged that "the combination of significant sunk investment, declining technology costs, and competitive

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[8] *Compare, e.g., Petition for Arbitration*, Nos. TO-97-40 & TO-97-67, slip op. at 110-14 (Mo. Pub. Serv. Comm'n July 31, 1997) (adopting for example a 13.7 year depreciation life for aerial fiber cable), *with Depreciation Requirements for Incumbent Local Exchange Carriers*, 15 FCC Rcd. 242, app. B (1999) (adopting a prescribed depreciation range for aerial fiber cable of 25 to 30 years).

[9] *See, e.g., In-Region InterLATA Servs. in Kan. & Okla.*, No. 00-217, slip op. ¶ 76 (F.C.C. Jan. 22, 2001) (upholding depreciation lives even though they were lower than the FCC's prescribed depreciation lives and pointing out that the FCC has "never stated that states should be precluded from setting depreciation rates that differ from the Commission's").

entry may increase the . . . cost of capital of incumbent LECs" (Order, ¶ 686 (JA 384)), and it required that states set network element rates that include a "cost of capital that appropriately reflects the risks incurred by an investor." *Id.* ¶ 703 (JA 396). There is no merit to any of the LECs' objections to this aspect of the Order.

First, they complain that the FCC mandated that states use the federally prescribed rate of return of 11.25% if the parties to the state proceeding do not propose a higher or lower rate of return. Bell Br. 31-32. But again, this is just a default rule. Moreover, the 11.25% was established in 1990 when interest rates were much higher than today, and states and federal courts that have addressed the LECs' cost of capital in providing network elements have generally determined that 11.25% is too high under current conditions.[10]

Next, Bell claims (*id.* at 30) that the FCC erred by refusing to prescribe a rate of return of 22%-33% and by instead leaving rate of return calculations to state commissions. It notes that LECs presented "evidence" (an affidavit of Dr. Jerry Hausman) that the LECs' cost of capital under TELRIC and the 1996 Act will be "at least two to three times higher than the rate of return authorized in the old monopoly environment," and contends that it was arbitrary for the FCC to refuse to impose Hausman's view on the states.

This claim is baseless. AT&T and MCI each submitted detailed expert affidavits that demonstrated that Hausman's

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[10] *See, e.g., Bell Atlantic-Virginia, Inc.*, No. PUC970005, 1998 WL 352676, at *3, *8 (Va. State Corp. Comm'n May 22, 1998) (10.12 percent); *Approval of Agreements & Arbitration of Unresolved Issues*, 180 P.U.R.4th 521, 531 (Md. Pub. Serv. Comm'n 1997) (10.1 percent); *Nextlink Pa., Inc.*, 196 P.U.R.4th 172, 210 (Pa. Pub. Util. Comm'n 1999) (9.83%); *Bell Atlantic-Delaware, Inc.* v. *McMahon*, 80 F. Supp. 2d 218, 239-41 (D. Del. 2000) (upholding rate of 10.28%); *Southwestern Bell Tel. Co.* v. *AT&T Communications of the Southwest, Inc.*, No. A 97-C-132-55, 1998 WL 657717, at *13 (W.D. Tex. Aug. 31, 1998) (upholding rate of 10.36 %).

affidavit should be given no weight. They showed that it was based on a misunderstanding of standard cost of capital models, that it made such errors as confusing nominal and real interest rates, and that it rested on unfounded assumptions about the rate of construction of alternative facilities (that have been disproven by the intervening events over the past five years). JA 215-63. Further, based on this testimony, the FCC explained in some detail why it was "not persuaded" by the LECs' "evidence." Order, ¶¶ 686-689 (JA 384-86).

As this Court has held, it does not sit to umpire disputes among economists over ratemaking methodologies.[11] It would be peculiarly inappropriate to do so here, for the FCC's conclusions were well-founded. Beyond that, the FCC has not foreclosed the LECs from making these same claims to state commissions. It merely refused to rely on them to prescribe a rate of return that binds states. *Id.* ¶ 702 (JA 395-96).

The LECs next claim that the FCC arbitrarily prohibited states from deviating from the default (11.25%) cost of capital until "actual competition had in fact materialized." Bell Br. 32. That, too, is wrong. The FCC simply refused to require states to accept the LECs' unsupported assumption of massive and instantaneous entry that strands LEC investment, for the FCC concluded (correctly) that "[t]he more reasonable assumption" is one "of entry occurring over time" that will have little effect on LECs. Order, ¶ 688 (JA 386). Again, moreover, the FCC's Order did not bar LECs from making their contrary claims in the state proceedings.

The LECs also misstates the Order in contending that it prohibits states from adopting network element rates that would protect LECs against "emerging competition [that] threatens to strand investment" by allowing them to

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[11] *American Commercial Lines, Inc.* v. *Louisville & Nashville R.R.*, 392 U.S. 571, 590 (1968); *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92 (1968).

"*frontload* their recovery of costs." Bell Br. 31-33. As noted, the FCC did not bar states from adopting accelerated depreciation, which would result in rates that are dramatically higher in the early years of an investment. See *supra*.[12]

For these and other reasons, it is spurious for LECs to argue that TELRIC destroys the incentives of competitive local exchange carriers ("CLECs") to invest in facilities. Qwest Br. 21; Bell Br. 24, 29. The risk that CLECs will do so is reflected in the TELRIC-based rates that they must pay for network elements. Further, to foreclose any claim that TELRIC "may discourage facilities-based competition," the FCC required that TELRIC calculations be based not on the most efficient network design, but on LECs' existing wire centers. Order, ¶¶ 683, 685 (JA 382-84). Moreover, because of the enormous transaction costs that CLECs incur in using network service elements, they will have incentives to invest in alternative facilities whenever that is remotely feasible. These points are all confirmed by AT&T's massive investments to construct facilities that it could obtain as network elements.

d. The LECs also argue that the FCC's Order rests on the premise that prices will "instantly" drop because of the "mere availability of a new technology, whether in a lab or in the channels of commerce." Qwest Br. 30. In this regard, they rely on the fact that Professor Baumol has since stated that *if* TELRIC so assumed, "minor readjustment[s]" may be required. W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose?*, 73 N.Y.U. L. Rev. 1122, 1147 (1998). But the FCC's Order makes no such assumption. TELRIC requires that rates be based on the most efficient technology proven to be "operationally feasible and currently available." Order, ¶ 683 (JA 383). Further, there is

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[12] The LECs also erroneously argue that the FCC unlawfully refused to allow them to charge "above-cost" rates to foster "innovation." Qwest Br. 35. Section 252(d)(1)(A) squarely prohibits above-cost rates.

nothing "instantaneous" about the implementation of TELRIC. Because of the period of time required to collect data, to prepare and decide a rate case, and to implement the resulting interconnection agreement, a period of several years generally passes between the commercial installation of efficient new technology in LEC networks and the availability of network elements at the rates that reflect the existence of the technology.

4. Against this background, there is no basis for the LECs' assertions that the FCC here attempted to divine the prices that would prevail if telecommunications service were a perfectly competitive market and to "short circuit" the competitive process by imposing these rates by "regulatory *diktat*." Bell Br. 24; Qwest Br. 21, 22. The FCC was addressing rates for facilities found to have substantial "bottleneck" characteristics in today's telecommunications market. These rates are based on "actual prices" that prevail in today's *monopoly* market when LECs install new network elements or replace existing ones using efficient technology (*i.e.*, the best practices of today's monopolists). The rates are to further rest on depreciation and rate-of-return calculations that reflect the LECs' risks in operating under TELRIC in today's conditions. The FCC did not (and could not) even attempt to divine what the prices would be in a market in which multiple firms could economically provide loops, switches and other network elements and in which their innovation in developing, providing, and provisioning the underlying equipment would surely lead to dramatic reductions in their costs and dramatic improvements in their efficiency and capabilities.

By making bottleneck facilities available at the "economic costs" that LECs in fact now incur in providing network elements in today's monopoly market, the 1996 Act and the FCC's Order merely created the possibility of innovation and competition in providing those elements of retail telephone services that do not have natural monopoly characteristics and

that Justice Breyer referred to as the "unshared" segments of telecommunications. Allowing *this* competition institutes a process that will drive retail prices closer to cost. In this regard, it is ironic that Qwest (Br. 21 n.11) relies on the FCC's decision not to prescribe cost-based exchange access charges. There, the FCC expressly relied on the fact that competitors who rely on network elements leased at TELRIC-based rates will drive access charges closer to competitive levels. The LECs' citations thus refute their accusations.

5. Finally, the alternatives to TELRIC that the LECs identify are all historical-cost methods that the FCC properly rejected for the reasons stated in the respondents' briefs of AT&T, the FCC, NARUC and WorldCom. First, that is the case with Qwest's purported "actual forward-looking costs." Qwest would set rates based on the sum of (1) the LECs' incremental costs over an "intermediate horizon," and (2) a return of and on its "fixed" investments in "any existing facilities that would remain in place during that time period." Qwest Br. 39. But as the FCC correctly held (Order, ¶ 686 (JA 384-85)), this is an improper historical-cost method. It allows recovery for "fixed costs on the old equipment – the depreciation that may not yet have been fully recovered, the return on the net investment not fully written off, interest on the debt already incurred." 1 A. Kahn, *The Economics of Regulation* 118 (1988).

For this reason, the FCC also properly rejected the so-called efficient component pricing method. Under it, rates for network elements would be set by taking the LECs' existing retail revenues and subtracting the LECs' incremental costs of supplying the retail and other inputs that its competitors will supply. But this method can result in efficient-component prices only if the retail revenues are capped by TSLRIC and are cost-based. W. Baumol & J. Sidak, *Toward Competition In Local Telephony* 108 (1994). As the FCC found, the LECs' "existing retail rates . . . are not cost based" and this method is thus "improper." Order, ¶¶ 708-711 (JA 401-03).

Qwest also mentions a "price cap" method – which no party advocated below. It would use historical costs to set initial network element rates and make annual adjustments to reflect increases in productivity. The FCC has also found that such methods do not result in cost-based rates. *Rates for Dominant Carriers*, 2 FCC Rcd. 5208, 5211-12 (¶ 22) (1987). Thus, price caps would violate the statute.

II. THE NETWORK ELEMENT COMBINATIONS RULES ARE VALID.

As AT&T's Petitioner' Brief demonstrated (40-46), the Eighth Circuit's refusal to reinstate Rules 315(c)-(f) rests on its conclusion that the "plain language" of the second sentence of Section 251(c)(3) prohibits the FCC from requiring combination of elements. This holding cannot be reconciled with this Court's holdings that (1) the second sentence is "ambiguous" and "does not say, or even remotely imply, that elements *must* be provided only in [discrete pieces] and never in combined form," and (2) "rational" network element combination rules that implement the "nondiscrimination requirement" imposed by Section 251(c)(3)'s first sentence are therefore lawful. *Iowa Utils. Bd.*, 525 U.S. at 394-95 (emphasis in original).

The LECs' arguments here are likewise at war with these holdings.[13] For example, the LECs' contention that Section 251(c)(3)'s second sentence "cannot [be] read . . . as *authorizing*" Rules 315(c)-(f) (Bell Br. 48 (emphasis in original)), attacks a strawman. As the Court found when it upheld Rule 315(b), these rules are authorized by the first sentence of Section 251(c)(3), not the second. The second

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[13] The LECs reiterate, virtually verbatim, the contention they made in opposing certiorari that this issue has been "abandoned." Bell Br. 41-43. That contention was "necessarily considered and rejected" when certiorari was granted, *United States* v. *Williams*, 504 U.S. 36, 40 (1992), and is no longer properly before the Court. It is also meritless for the reasons stated in AT&T's Reply Brief in support of its petition for certiorari (pp. 8-9).